THE LOAN ZONE

FOR THE PAST 18 MONTHS THE SYNDICATED LOAN MARKET HAS BEEN WEIGHED DOWN BY A LACK OF M&A ACTIVITY. BUT ALL THAT LOOKS SET TO CHANGE, SAYS **TESSA WALSH** OF LPC.

The syndicated loan market, which came to rely on mergers and acquisitions (M&A) bounty as its staple fare, has had a rude awakening over the past 18 months. Diminishing 2002 M&A lending was only rescued late in the first quarter by the €5.5bn and £250m loan for Imperial Tobacco, which backs its acquisition of Germany's Reemtsma.

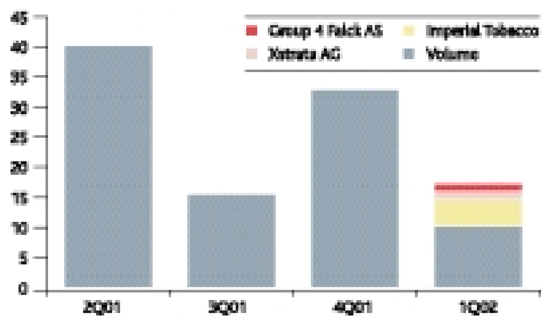
M&A was largely absent for much of the first quarter, but a trickle of deals in late March suggests that companies have started to think strategically instead of defensively again. "There is not enough activity to suggest we are through the slump, but there is more talk of levels picking up. I am confident that companies are now looking and thinking strategically," commented one banker.

Bankers say that companies are starting to see the bottom of the economic cycle and appreciate that now could be the time to go shopping before more concrete signs of recovery boost target prices. Imperial Tobacco's loan proved to be the fix the market was waiting for to resuscitate M&A volume, which had even been drifting below 2001's $15.35bn troubled third quarter low.

This year's $17.15bn of M&A loans is 48% down on the fourth quarter, suggesting that the modest rally at the end of 2001 was more a result of market momentum than increasing M&A activity, according to research by LPC. The subsidence in M&A activity is even more pronounced over a longer timeframe. The first quarter of 2001 shows a far larger 61.5% decline on the same period last year, which was already 32.6% down on the first quarter of 2000.

There is very little rocket science to M&A lending, which consists of investment-grade acquisition facilities and riskier non-investment grade leveraged buyouts (LBOs). The loan market is geared towards and excited by large income-boosting investment-grade M&A deals that offer substantial acquisition premiums for the speed, size and confidentiality of the deal, and often lead to further bond or equity markets mandates under the integrated one-stop shop approach. The loan market's position at the forefront of acquisition finance looks likely to remain unchallenged as cash is king in the depressed equity environment, particularly as the commercial paper (CP) market has become more unpredictable and expensive for users with declining ratings.

FIGURE 1
WESTERN EUROPE M&A VOLUME TRENDS.



Source: Loan Pricing Corporation

The loan market's place in M&A finance is primarily as a bridge solution to rapid capital markets takeouts through bonds or equity issues or disposals, which are designed to delever credits quickly.

One banker explains: "The bank market has its benefits in M&A financing. Getting large amounts of capital quickly gives you time to align the debt to the cashflow of the company, usually with bonds."

Investment grade acquisition loans are not built to last, and the initial interest margin is kept high to encourage borrowers to refinance the bulk of the deal quickly. A trend towards short-termism has become apparent in M&A deal structures. Arrangers are pushing for larger one-year tranches and three-year facilities instead of five years as the pressure to increase shareholder returns has made banks keen for quick churn on their balance sheet.

The first big M&A loan of the year, Swiss mining company Xstrata's $2bn facility which financed its purchase of coal businesses from Glencore International in mid-February, was partly refinanced a month later with an unusual equity takeout. The loan market has become more used to bond issues or disposals as preferred takeout options in the recent depressed equity environment. Xstrata's deal, which successfully re-introduced underwriting to a market sceptical of meeting sell-down targets, quickly reduced its loan to $1.4bn with the $840m proceeds of its London flotation. This cancelled the deal's

$600m, 364-day tranche, which was priced at 137.5bp over Libor.

A speedy takeout – this time via bonds – has been a key selling point of Imperial Tobacco's large loan to reduce post-acquisition leverage of about four times. For the first time on a big acquisition, Imperial's loan at 175bp over Libor, was priced over the company's 2004 and 2006 bonds, which were trading at 139bp and 141bp respectively on an asset-swapped basis.

Banks advise against using the spread as a new acquisition benchmark, as it was designed to overcome doubts about lending to the sector and pre-empt the relative value play that nearly scuppered France Telecom's €15bn refinancing. Soaring FRN and credit protection spreads made France Telecom's loan look poor value for money to investors shopping around.

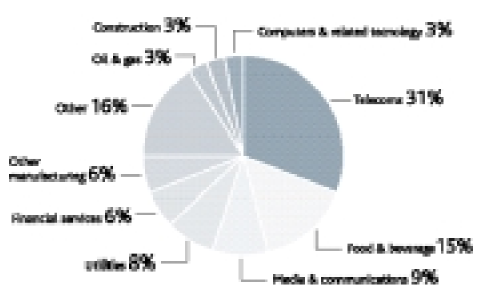
The trend towards short-termism in M&A lending is apparent on Imperial's acquisition loan, 38% of which has a 364-day maturity and Xstrata's $2bn loan, 30% of which was a 364-day credit.

BRIDGING THE GAP. All the deals mentioned so far have been designed to be part-refinanced but recent utility deals have structured as straight bridge loans, which will be fully refinanced with bonds, as seen on German utility RWE's €5bn bridge loan, which covers its purchase of UK utility Innogy. The €3.7bn acquisition of Italian utility Eurogen by the Edipower consortium, led by Edison-Sondel, is also relying on a €4bn bridge loan. New thinking on more traditional M&A deal structures has yet to manifest itself, as deals launched this year have been under construction for six months. Syndicators estimate that any 2002 deals are unlikely to appear before the end of the summer. The Imperial loan, together with the £680m loan for UK publisher Johnston Press, which backs its acquisition of Regional Independent Media, the other 'budget buster' which will net banks participating in both deals £500,000 in fees, were both originated last year.

The good news for the arrangers is that the lack of deal flow has created almost unlimited bank appetite for income-generating sizeable M&A financings, and all recent deals have met with enthusiastic market receptions.

According to one banker: "Lending volumes have been down over the past 18 months, and banks are looking to beef up assets to generate some revenue. The banking community have also been reassured by the appearance of smaller deals, such as the £425m facility for the UK's Davis Group, backing its acquisition of Denmark's Sophus Berendsen, which they believe mark the appearance of more predictable deal flow.

FIGURE 2
M&A VOLUME BY INDUSTRY: FULL YEAR 2000.



Source: Loan Pricing Corporation

Volume will also be boosted by acquisitions awaiting regulatory clearance, such as the €1.34bn loan for Danish security firm Group 4 Falck, which backs its $573m acquisition of Wackenhut of the US.

M&A finance has not been immune from wider loan market developments, stemming from the run of recent credit shocks. The bumpy credit environment has focussed bankers on credit self-protection, primarily increased covenants.

STEADY STREAM OF LBOS. Riskier non-investment grade private equity-supported LBOs, the most active sector of the loan market last year, have supplied a slow but steady deal flow as corporate disposal programmes grind on. Although large buyouts, such as the €5bn buyout of French switch maker Legrand and the $1.1bn buyout of the UK's National Car Parks, are pending, new business has been slow this year, with only $3.04bn of deals completed in the first quarter – 24% down on the fourth quarter and 61% down year on year.

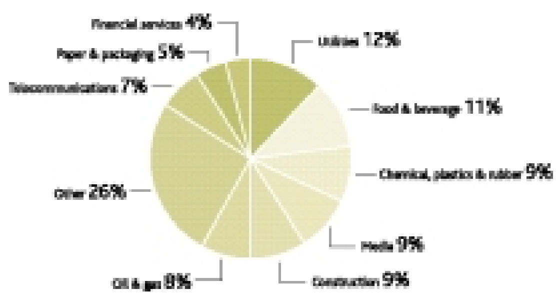
Banks can expect some less standard deals as the pipeline is also being boosted by a couple of large telecom sector buyouts and leveraged recapitalisations, bankers say. Telecom LBOs are relatively new territory for private equity sponsors. The sale of a 78% stake in dominant Czech operator Cesky Telecom will see private equity sponsors teaming up with telecom operators in a new move designed to overcome sponsors' lesser relationship appeal.

With the stock market on go slow, private equity firms are keen to release cash from their performing investments. The successful first quarter recapitalisation for Irish drinks distributor Cantrell & Cochrane is expected to be followed by a reworking of a £120m facility of 1999 for UK furniture business Hillsdown Holding, and a £624.5m facility from 2000 for UK caravan business Bourne Leisure.

Structural developments on the LBO side have been confined to mezzanine finance, which is enjoying a renaissance and has proved more popular than senior debt of late.

But traditional mezzanine investors used to returns of 16%-18% have been alarmed by the increased usage of second secured loans offering returns of about 10%, which are replacing high-yield bonds on lower leveraged businesses sponsors are looking to turnaround quickly. Even these lower hybrid senior debt/mezzanine returns have come under pressure lately. The £40m mezzanine facility backing the LBO of funeral home Dignity offered a return of just 8%.

FIGURE 3
M&A VOLUME BY INDUSTRY: FULL YEAR 2001.



Source: Loan Pricing Corporation

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